LESSON 6B:

DEBT SECURITISATION

6B.0 : Objective:

After reading this lesson, you will be able to understand

- Meaning of securitision
- Process of securitisation
- Benefits of securitisation
- Provisions of securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Structure:

6b.1 Introduction :

Ever expanding economic activity require continuous supply of capital resources. Accessing funds from the capital market is the crux of the problem. As alternative to traditional modes of fund raising like issue of equity, debentures, deposits, etc new methods like leasing, hire purchase, asset securitisation etc are gaining popularity. Developments in the financial sector led to the use of new and innovative financial techniques and financial instruments.

Securitisation is conversion of existing or future cash inflows of any person into tradable security, which can be sold in the market. The cash inflows from financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, fare collections become the security against which borrowings are raised.
Banks and financial institutions make loans and advances for the purchase of assets such as cars, houses, tracks, machinery etc. They hold a pool of individual loans and receivables that generate cash flows. Securities are created against them, which are rated and sold to investors.

6b.2 Meaning :

Securitisation in “a process by which the future cash inflows of an entity are converted and sold as debt instruments with a fixed rate of return to the holders of beneficial interest”.

Securitisation is “the process of conversion of existing assets or future cash flows into marketable securities. Securitisation deals with the conversion of assets, which are not marketable into marketable ones.

Conversion of existing assets into marketable securities is known as asset – backed securitisation and conversion of future cash flows into marketable securities is known as future flows securitisation. Assets that can be secuiritised are loans like car loans, housing loans etc. Future cash flows that can be securitised are credit card payments, ticket sales, car rentals or any other form of future receivables.

According to the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, securitisation means “acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial asstes or other wise”.
The last part of this lesson deals with legal framework of the Act.

6b.3 Process of Securitisation :

The process of securitisation starts which recreation of loans into homogeneous pools. The pools are formatted according to type of credit, maturity pattern and interest rate risk. These asset pools are transferred to a trustee or an issuer. The issuer issues securities, which are sold to the prospective investors. The issuer is given legal protection in the form of an undertaking that these securities are being placed in the market without recourse to the seller. Each issue of securities has a servicer responsible for collecting interest and principal payments on the loans in the underlying pool of assets and for transferring funds to the investors. The issues are rated by rating agency on the basis of structure of issue, underling pool of assets, expected cash flows, extent of loss protection provided to investors, degree of credit enhancement, etc. The rating normally improves the sale ability of an issue.

A typical securitisation deal has the following stages:-

i) The originator (owner of a financial asset) determines which assets he wants to securitise for raising funds.
ii) A trust or special purpose vehicle (SPV) formed for the securitisation purpose acquires the financial assets from the originator under an agreement at their discounted value.

iii) The SPV issues securities to the investors and SPV in funded by the investors
iv) The servicer to the transaction is appointed by the originator.
v) The servicer collects the receivables and pays off the collection to the SPV
vi) The SPV passes the collections to the investors or reinvests the collections to pay off to investors.
vii) In case of default, the servicer takes action against the debtors as the SPV's agent.
viii) When a small amount of outstanding receivables are left to be collected, the originator may clean up the transaction by buying back the outstanding receivables.
ix) At the end of the transaction, the originator's profit, to the extent agreed by the originator, in the transaction is paid off by the SPV.

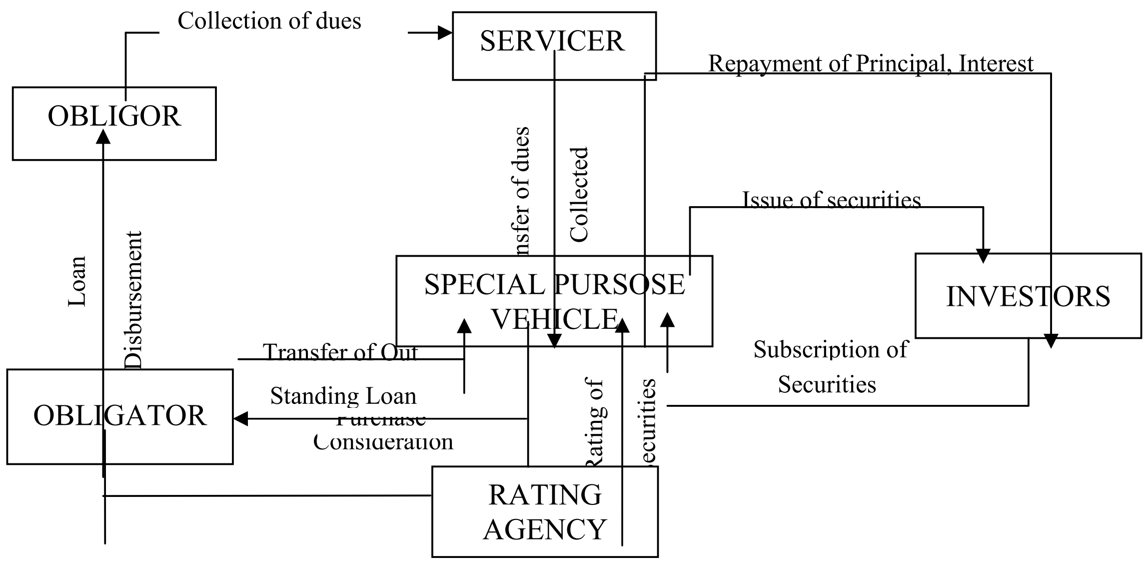

Fig 6b.Securitisation Process.

6b.4 Parties to a Securitisation Transaction :

Primarily originators, special purpose Vehicle (SPV) and investors are the parties to a securitisation transaction. The obligors, rating agency, servicer are other agencies involved in the transaction.

(a) **<u>ORIGINATOR:</u>**

Originator is the entity on whose bocks the assets to be securitised exist. Originator sets up the required structure-originator is the entity whose future cash inflows are sold.

(b) **<u>SPECIAL PURPOSE VEHICLE (SPV):</u>**

An SPV is an entity specially created for doing the securitisation deed. It invests investment from investors, uses the invested funds to acquire the assets or receivables of the originator and then uses the realisations from the receivables transferred to it to pay the investors, there by giving them a reasonable return. An SPV may be a trust, corporation or any other legal entity. Its activities are

- Holding title to transferred financial assets.
- Issuing beneficial interest.
- Collecting cash proceeds from assets held.
- Reinvesting proceeds in financial instruments

- Distributing proceeds to the holders of beneficial interest.

(c) **Investors:**

The investors may be institutional investors or individual investors. Financial institution, mutual funds, banks, insurance companies and provident funds constitute institutional investors.

(d) **Obligor(s):**

The obligors are the original borrowers. They are the debtors of the originators. The amount outstanding from the obligor is a financial asset that is transferred to a special purpose vehicle (SPV).

(e) **Rating Agency:**

The rating agency assesses the strength of the cash flow, mechanism for the timely payment, credit quality, extent of liquidity support, strength of the legal framework etc. Based on the rating, investors take on the risk of investing.

(f) **Servicer:**

Servicer collects the payments due from the obligors and passes it to the SPV. It pursues legal remedies available against the defaulting borrowers.

6b.5 Instruments of Securitisation:

The instruments of recuritisation are

i) Pass through Certificates
ii) Pay through Certificates
iii) Stripped Securities

6b.5.1 Pass through Certificates:

It is an instrument, which signifies transfer of interest in the financial asset in favour of the holder of the pass through certificate. The investors in a pass through transaction acquires the receivables subject to all these fluctuation, prepayment etc. The material risks and rewards in the asset portfolio, such as the risk of interest rate variations, risk of prepayments etc are transferred to the investors. The features of pass trough certificates are

i) Investors get a proportional interest in pool of receivables
ii) Collections are divided proportionally
iii) All investors receive proportional payments
iv) There will be no reinvestment of cash collected by the SPV

6.5.2 Pay through Certificates:

In case of pay through certificates the SPV issues debt securities like bonds repayable on fixed dates instead of transferring undivided interest on receivables. The bonds would he backed by the mortgages transferred by the Originator to the SPV. The SPV may make temporary reinvestment of cash flows to the extent required for bridging the gap between the date of payments on the mortgages along with the income out of reinvestment to retire the bonds.

6b.5.3 Stripped Securities:

Securities are Classified as “Interest Only” (IO) or “Principal Only” (PO) under this category. IO securities are paid back out of interest income only while PO securities are paid out of principal repayments only. There securities are highly volatile in nature and are least preferred by the investors. PO securities increase involve when interest rates go up. These securities are traded by speculators who make money by speculating about interest rate charges.

6b.6 Advantages of Securitisation:

i) Securitisation helps in raising funds at a rating higher than what is the actual rating of the originator

ii) Securitised assets go off the balance sheet of the originator

iii) If is especially helpful in the banking industry to satisfy the capital adequacy norms

iv) The asset portfolio is liquidated releasing cash which in term reduces the need for demand and time liabilities that are subject to statutory reserves in case of banks

v) Small investors con profit from such deals since they can invest small sums in the SPV and acquire beneficial interest.

vi) Securitisation keeps the other traditional lines of credit undisturbed.

6b.7 Demerits of Securitisation:

i) True picture of the originator's financial position as can not be known as Securitisation is off-balance sheet funding.

ii) If the lest assets of the company may be left with sub-standard assets on its books.

iii) Huge liabilities taken by a company may net appear on the balance sheet leading to lack of transparency.

iv) The SPV has the right to recover the dues from the originator if assets securitised become bad.

v) The originator may have a lot of contingent liabilities without any one being aware of it.

6b.8 Securitisation in India:

Based on the recommendations of Narasimham Committee I and II and Andhyarujina Committee a new legislation for securitisation and empowering banks and financial institutions to take possession of the securities and to sell them without the intervention of the court has been enacted. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 came into force on 21st June 2002. Its purpose is to promote the retting up of asset reconstruction / securitisation companies to take over the Non performing Assets (NPAs) accumulated with the banks and public financial institutions.

In a conventional lending process a bank disburses a loan, maintains it as an asset on its balance sheet, collects principal and interest and monitors whether there is any determination in the borrower's credit worthiness.

This process requires a bank to hold assets (loans) till their maturity resulting in blocking of funds. Securitisation releases these funds so that they will be available for further lending.
The lending bank is known as originator an the borrower is the obligor.

One type of asset (e.g. auto loans) of similar maturity are bundled together and transferred to the SPV (asset reconstruction / securitisation company) for the purpose of creating the securitised instrument. The SPV divides the assets in to marketable securities. Qualified Institutional buyers (QIBs) who possess the expertise and the financial strength to invest in securities market are allowed to invest in these securities. Mutual funds, financial institutions, scheduled commercial banks, insurance companies, provident funds, pension funds, state industrial development corporations fall under the category of QIBs.

The rating agency rates the securities based on the asset quality securities rated high offer low risk and high yield and vice versa.

A servicer is appointed to collect payments from the obligors. The servicer follows with the defaulters and uses legal remedies against them. Normally the originator carries out this activity.

The securitised assets will be removed from the books and funds generated will be used for giving new loans.

Features of the Act:

I. Securitisation and Reconstruction of Financial Assets of banks and Financial Institution

1 Securitisation Company or Reconstruction Company should obtain certificate of registration.

2 The company should have own funds of not less Two Crore rupees

3 Securitisation Company or Reconstruction Company may acquire financial assts of any bank or financial institution by issuing a debenture or bond for consideration agreed upon.

4 Securitisation Company or Reconstruction Company will be deemed to be the lender and all rights of such banks or financial institutions will be vested in Securitisation Company or Reconstruction Company in relation to the financial asset acquired.

5 All contracts, deeds, bonds, agreements, power-of-attorney, grant of legal representation, permissions, approvals, consents or no objections relating to the financial asset are deemed to have been issued in favour of the Securitisation Company or Reconstruction Company.

6 Securitisation Company or Reconstruction Company may apply to the Appellate Tribunal for transfer of all pending application to any one of the Debts Recovery Tribunals if any financial asset comprises of second debts of more than one bank or financial institution. If the bank or financial institution has filed applications before two or more Debts Recovery Tribunals.

7. The Securitisation Company or Reconstruction Company may offer security receipts to qualified institutional buyers (Q1Bs) for subscription.

8. A Securitisation Company or Reconstruction Company may raise funds from the Q1Bs by formulations schemes for acquiring financial assets. Realisations of such financial asset should be used for redemption of investment under the scheme.

9. A Securitisation Company or Reconstruction Company may provide for the following measures for the purpose of asset Reconstruction

- Proper management or change in or takeover of the management of the borrower's business.
- Sub or lease of a part or whole of the borrower's business
- Rescheduling of payment debts payable
- Enforcement of security interest
- Settlement of dues payable by the borrower
- Taking possession of secured asset.

Enforcement of Security Interest:

1. Any secured interest created in favour of any secured creditor may be enforced, without the intervention of Court Tribunal, by such creditor.
2. Secured creditor can classify a secured debt as non-performing asset (NPA) in case of default in repayment.

3. If the borrower fails to discharge his liability in full with in the specified period, the secured creditor may take the following measures to recover the secured debt.

- Take possession of the secured asset
- Take over the management of the business of the borrower including the right to transfer the secured asset
- Appoint manager to manage the secured assets whose possession has been take over by the secured creditor
- Require any person who has acquired the secured asset from the borrower and from whom money is due to pay the secured creditor

4. If the sale proceeds are not sufficient to recover the dues, the secured credit may file on application with the Debt Recovery Tribunal for recovery of the balance amount from the borrower.

6b.9 Summary:

Asset securitisation is the process of bundling similar type of financial assets like loans receivables, transferring them to special purpose vehicle, issuing of securities by SPV and there by raise funds for business purpose. In India securitisation is permitted only in the case of banks and financial institutions. Banks are able to transfer Non performing assets to the securitisation company and reconstruction company.

6b.10 Self Assessment Questions:

1. Explain the process of securitisation ?
2. What are the various instruments of securitisation ?
3. What is a SPV? How does it operate?
4. Bring out the merits and demerits of securitisation?
5. What are the salient features of the Securitisation and Reconstruction of financial assets and Enforcement of Security Interest Act, 2002?

6b.11 Further Readings:

1. S. Gurusamy, “Financial Services & Systems”, Vijay Nicole imprints Pvt. Ltd., Chennai, 2004.

2. The Securitisation and Reconstruction of Financial ssets and Enforcement of Security Interest Act, 2002, Gogia Law Agency, Hyderabad.

3.M.Y. Khan, “Financial Services”, Tata Mc Graw Hill Publishing Company ltd., New Delhi, 2006b.

4.L M Bhole, “Financial Institutions and Market”, Tata McGraw Hill , Publishing Company Ltd. New Delhi.

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